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October 21, 1994

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The Honorable Reed E. Hundt
Chairman
Federal Communications Commission
1919 M Street, N.W.
Room 814
Washington, DC 20036

RE: Ex Parte Presentation in
MM Docket Nos. 92-266 and 93-215

Dear Chairman Hundt:

On behalf of our client, the City of St. Louis, Missouri, I write to address the so-called "going forward" rules for cable rate regulation now under consideration by the Commission. The City of St. Louis has recently been informed that Commission action is imminent on the "going forward" rules. The City wishes to share its views with the Commission. This ex parte communication will be filed in the record of Docket No.92-266.

I. Introduction.

The City of St. Louis asks the Commission to withhold action on the so-called "going forward" rules until opportunity is allowed for comment. The City believes the action under consideration violates the rules of fair notice and comment procedure, is unlawful under the terms of the federal Cable Act, and will severely injure consumers. The City believes the "going forward" proposal under consideration will not have the effect the Commission anticipates and has not been based on an adequate record of facts from all parties, as opposed to the self-interested, but largely unsubstantiated claims of the cable industry.

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If the Commission nevertheless proceeds to issue "going forward" rules without further notice and comment, it should act to mitigate the worst elements of the proposal and be prepared to revise its action on prompt reconsideration after thorough public comment.

II. Background

FCC staff has informally contacted various local government regulators recently, including officials at the City of St. Louis, and sought reactions to verbal presentations on possible "going forward" models intended to encourage cable operators to add new programming channels to cable systems. It was only on Thursday, October 13, 1994, that the City learned the Commission was considering imminent action to issue new rules outside of the normal Commission procedures for public comment and a review in a public Commission meeting. We received our first full briefing from the FCC on the proposal on Monday, October 17.

The comments in this letter are based on oral descriptions of the "going forward" proposal by the Commission staff. The City has not had the benefit of any written description of the proposal or proposed rules to consider or review.

III. FCC Staff Proposal

The "going forward" proposal is apparently prompted by the belief that the cable industry needs significant financial relief and inducement to add new programming to existing systems. We understand that the FCC is considering a mechanism that would allow "incubation" of a new programming service on a regulated tier, but at a price different than the benchmark rate authorized for the tier. The first year, the operator would be allowed a fixed mark-up per channel, multiplied by the number of channels plus the programming license fee, not to exceed a total capped amount for the sum of all new channels. Apparently this cap will disappear after the first year and the operator can then pass through any increase in licensing fees for each channel, regardless of the total rate increase that results. Additionally, the operator can migrate the new channel at will to a largely unregulated "new product" tier or to a la carte status.

IV. The Proposal Appears Illegal and Unnecessary

A. Public Comment

It is evident the Commission's plan will have a dramatic impact on subscribers' rates. It may cause rate increases that exceed all the rate reductions to date on the regulated tiers. If operators are allowed to exploit the new "going forward" rules in the same time frame as the annual permitted inflation adjustment for the regulated tiers (and, indeed, during the quarterly pass-through adjustments that franchising authorities are now receiving), all of the consumer savings to date under rate regulation will likely be wiped out immediately. Indeed, consumers will likely face even higher rates than before regulation.

Nevertheless, the Commission has chosen to develop and pursue this dramatic change in course almost completely through the *ex parte* process. The proposal has never been put in writing for public review and has never been subjected to public comment. While the staff of the Commission has orally briefed industry representatives repeatedly, there is no evidence that the general public, or their representatives, have been given equal access or adequate notice.

The FCC's earlier March 30, 1994, Fifth Notice of Proposed Rulemaking, at paragraphs 255-256, does not constitute public notice or reasonable opportunity for comment on the "going forward" proposal now under consideration. The current proposal is a derivative of industry proposals developed in extensive *ex parte* filings that have never been noticed for comment by other interested parties. Unlike the cable industry, the general public and local regulatory jurisdictions lack the resources to lobby the FCC extensively and to obtain copies and review extensive *ex parte* filings. They rely instead on public notice in the Federal Register. To argue that the general public and local franchising authorities have had adequate notice and opportunity to comment on the industry's *ex parte* proposals simply ignores this fundamental reality. It also violates the Commission's own rules and the very heart of the purpose of the Administrative Procedure Act.

B. No Public Emergency nor Demonstrated Need

There is no evidence, other than the industry's self-serving say-so, to suggest that any emergency exists to justify short circuiting the FCC's normal notice and comment and open meeting procedures. Staff at the FCC claim that the industry is in an "annual budget cycle" in October and failure to act will prevent new program purchases for 1995. But again, there is absolutely no record to support this claim. The claim appears false on its face. The FCC has never before stated that its rate regulation rules must be in place by October because of industry budgets. And those rules have consequences far beyond the instant revenues at issue. The purchasing cycle for buying and launching programming services is not related to the end of the calendar year. Fall programming schedules are in place for the major networks. The syndicators are available at any time to enter into programming contracts. And the history of new channel launches for the cable industry does not suggest any particular significance to the end of the year. In fact, most new channels are introduced on systems in conjunction with an upgrade of system channel capacity, which tends to occur around the time of franchise renewal.

Moreover, there is no evidence remotely suggesting any general collapse in the cable programming market. There certainly is no evidence suggesting that there are vacant, "dark" channels on cable systems waiting to be filled. On the contrary, if the Commission would give a meaningful opportunity for franchising authorities and others to comment on the matter, it would find that many operators have been adding channels since regulation. Perhaps more importantly, the Commission would be able to develop a more balanced record to determine whether there has been any significant decrease in the rate that channels are added since regulation. The City is confident that no such general decrease has occurred. Rather, the primary variable in adding channels is system capacity, which relates to the timing of system upgrades. The threat of telephone entry and DBS, however, leaves most sophisticated MSO's with little choice but to expand capacity, with or without rate relief.

To be sure, the City recognizes that uncertainty and delay concerning the final contours of rate regulation rules may have had an adverse effect on the industry's ability to plan. To a certain extent, that is an inevitable result of implementing rate regulation, which Congress found necessary to curb monopoly pricing. Moreover, while the remedy may be more certainty in rate regulation rules, any such increased certainty need not, and should not, take the form of giving the industry a special privilege for further monopoly pricing as an inducement to operators to take on new channels.

The real culprits in the allegedly slow pace of adding new channels (both before regulation and now) are: (1) operators' exploitation of bottleneck control over programming distribution, which should be addressed in vigorous enforcement of the Commission's programming access and leased access rules, not through giving windfall rate relief to operators; and (2) lack of channel capacity as the industry pauses before beginning system rebuilds. As the Commission is well aware, the industry claimed in the must-carry proceeding that it does not have adequate channel capacity. As systems go into rebuild, operators are moving toward larger capacity systems. That will create the opportunity and need for new programming.

In any event, the Commission surely must have noticed by now that the industry's story changes to suit its needs. In the must-carry proceeding and litigation, it argued, on the one hand, that must-carry constrained its First Amendment rights due to capacity channel limitations and, inconsistently, that operators should not be subject to regulation because, unlike broadcasting, there is no scarcity of capacity. Then, in seeking to water down program and leased access rules, the industry has argued that there is no need to worry about programming diversity because there is no shortage of diverse programming that systems can and do carry. Finally, in opposing leased access rule changes, the industry argues that truly viable leased access programmers can afford to pay high rates for carriage, even though the industry inconsistently argues here that generous "going forward" rules are essential for new programmers to survive.

C. "Forbearance" In the Face of Unreasonable Rates

An equally fundamental legal infirmity is posed by the suggestion the Commission will create a "new product" tier and then "forebear" from regulation of that tier. The recent decision in MCI Telecommunications v. FCC, 114 S. Ct. 2223 (1994), specifically forbade discretionary regulation in the face of contrary Congressional mandates. The Cable Act states which classes of service must be regulated. It requires the Commission to act affirmatively to regulate rates to assure they are reasonable.

Similarly, it is impossible, and improper, for the Commission to determine "reasonableness" of rates without reviewing the cable operators' underlying costs. Yet the Commission has no record whatsoever on the true cost of the additional channels. There is no cost study in process. There is no baseline of historical costs. The only basis for the Commission's price analysis appears to be an untested and uncommented-on assertion by a large MSO that its pre-regulation history of revenue recovery for new channel services averaged $0.31. This self-serving claim may or may not be true. Even if true, however, the Commission should remember that it is a reflection of the operator's pre-regulation monopoly pricing power, not the operator's just and reasonable costs to be allowed under regulation.

V. The Commission Should Not Abandon the Consumer's Need for Protection from Operators' Monopoly Power.

A. Unnecessary Rate Increases

The "going forward" proposal is certain to cause rate shock to consumers. And the Commission will be blamed. Most of the initial rate increase is likely to occur as soon as Commission rules permit--about the same time as the quarterly and annual adjustments already allowed by the FCC's rules.

The record does not demonstrate that operators need additional incentives above benchmark rates to add new channels. The Commission has already concluded that benchmark rates are compensatory. There is no record that the cost to the operator is different in carrying a new versus a pre-existing programming service.

The Commission appears to be adopting a moveable, and unsupportable, standard for identifying "reasonable rates". Just as there is no record to distinguish between the costs for basic tier and cable programming service tier rates, there is no justification for this proposed distinction between new and old programming. On the contrary, this appears to be an effort to increase revenues to operators with no assurance that programmers will be fairly treated or that consumers will benefit.

B. Unwanted Services at Increased Prices/Tier Padding

The City is concerned that the "going forward" proposal would allow, indeed encourage, operators to foist additional undesired services on consumers, leaving them no choice but to pay the increased prices.

The proposal has no protections against more shopping channels, more advertising channels, or double-recovery by operators through increased revenues paid the operator by the programmer. In other words, operators may decide to "take the money and run." A reasonable, profit-oriented operator is likely to decide the cheapest, least desirable programming should go on the regulated tier and consumer-desired programming should go on the unregulated tier. This would be profit-maximizing in particular markets. Even "good" programming is unlikely to provide overall lift to subscriber penetration of regulated tiers, so operators are likely to put desirable new programming on the unregulated tier. But they will not pass up the additional revenue opportunity the Commission is giving them. Since the Commission has made clear that there would be no content restrictions in the going forward rules, operators could fill the allotment of "incubated" channels with undesirable channels, or channels that pay the operator for carriage.

C. The Future of Basic Service

Consumers need a predictable, acceptable basic tier that does not vary in cost. The instant proposal would undermine this principle.

The operators will have discretion to change channels on the basic tier regularly and to alter prices accordingly. Local and federal regulators will be helpless to prevent this churn. While a new unregulated tier may only affect those who choose to take it, fluctuations in the basic tier affect every subscriber on the system. Experimentation and market tests should not be imposed on those subscribers who consciously choose the lowest tier of service. And those same subscribers are most in need of predictable, low prices.

At the same time, the City recognizes that the proposal apparently rejects migration of historical services to unregulated status. The City strongly supports this element of the proposal as sound policy. There is no reason to allow existing services that are fully compensated and available under regulation to move to unregulated status.

D. Cable Operator Monopsony Power

The proposal appears to fall short of protecting programmers--the very beneficiaries the Commission intends. It appears the cable operator will have unlimited discretion to negotiate the terms and conditions of carriage for the new channels. And the operator will have total control over whether the new service is on the regulated, "new product", or a la carte tiers.

To the extent operators do add additional channels, there might be some benefit to programmers. But the Commission should do a better job of assuring the financial gain from additional revenues goes to the programmers, not the bottleneck cable operator. The flat mark-up per channel allowed by the proposal would permit operators to recover the lion's share of any rate increase, even though it appears the marginal cost to operators of adding a new channel is near zero.

VI. Administrative Problems in the Proposal

A. Cap on the Regulated Price

It is essential that the Commission extend the price cap to future years, as long as an incubated channel is on a regulated tier.

The current proposal of a one year price cap guarantees price manipulation as programmers voluntarily agree to minimum first-year programming license fees in return for mammoth boosts in future-year license fees. The price cap on programming cost pass-throughs should remain in place as long as the channel is subject to regulation. An inflation adjustment is the only appropriate modification.

Programming contracts often have multiple year terms. Like professional sports contracts with team salary caps, operators and programmers will adjust prices yearly based on the regulatory opportunities. A one year price cap limit on new programming cost pass-throughs will provide no real protection.

If the Commission is unwilling to freeze programmer payments in future years, then an alternative is to sunset the incubation period for the channel. The operator, assuming incubation is needed, should be put to the choice after a reasonable period of leaving the channel on a regulated tier under benchmark prices; shifting the channel to the unregulated tier or ala carte; or dropping the channel as a poor programming choice. The operator should not be given a permanent loophole exception to the benchmark rates.

B. Coordination with Existing Regulations

The new system should be simple and not confusing. The best solution is to limit the incubated channels to the cable programming service tier. This avoids the churn in basic services and prices. It allows subscribers an essential element of choice, and it leaves regulatory enforcement exclusively to the FCC, rather than imposing additional costs and burdens on already overburdened local franchising authorities.

If the FCC insists that incubated channels can appear on basic, the authority of local regulators to examine all elements of programming contracts must be crystal clear. And the channels must be separate and apart from the benchmark methodology. Otherwise every jurisdiction will have to recalculate the Forms 1200, placing yet another burden on franchising authorities.

The channels should be counted as part of basic or as part of the overall system channel count only once per year, at the time of the normal adjustment to the Form 1200 calculation.

Any revenues received by the operators from the programmers on the incubated channels or subscribers must be offset against pass-through costs to avoid operators double counting expenses for benchmark regulation or cost of service regulation purposes.

VII. Conclusion

The proposed "going forward" rules are not available in written form for comment. These comments by the City of St. Louis are based on oral descriptions received from Commission staff.

The City of St. Louis is concerned that the proposed rules are fundamentally flawed. They appear to be contrary to APA procedures and to the Cable Act. They also appear counterproductive to the goals of the Commission in reducing cable operator monopoly power and prices. And there is no record that the problem presented is real.

If the Commission is determined to move forward without a period for public comment, then St. Louis asks that the Commission pay particular attention to three specific problems. First, do not allow the operators and programmers to avoid the price cap by delaying price increases to the second or later years. An inflation adjustment is more than adequate. Alternatively, a sunset period for the incubated channel makes sense. Second, do not allow incubated channels on the basic tier. This will minimize consumer and regulatory confusion. Third, think carefully about the relationship of the incubated channels to the benchmark system of regulation.

Very truly yours,

MILLER, CANFIELD, PADDOCK AND STONE

By

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